time of the hair stylist and inputs such as shampoos. For the purposes of this example, I assume that there are differences in the variable costs of serving male and female customers, due perhaps to higher costs of shampoo for female customers compared to male customers.[2]

18. To keep the example simple, I also make the following assumptions: (i) that all hair stylists are alike, with each constituting a separate firm; (ii) that there are no barriers to entry in the industry; (iii) that each stylist works a fixed number of hours and faces a demand for hair styling that is known with certainty and is inversely related to price; and (iv) that stylists spend the same amount of time with both male and female customers.

19. Under these conditions, the prices charged for hair styling services would exceed the variable cost of providing a unit of service -- the time cost or wage of the stylist plus the cost of the shampoo used. These margins -- price less variable cost -- are necessary for the stylist to cover the fixed costs of its operation. Stylists would enter or exit the industry up to the point that each would be fully employed.

20. Under competitive conditions, the stylist would also charge different prices to male and female customers. The difference in prices, however, would just equal the difference in variable costs associated with a unit of output, and the margin earned on the services provided to women would just equal the margin earned on the services provided to men.

21. Other pricing patterns would not be sustained under competitive conditions. If a stylist charged each customer a price that just equalled the variable cost of serving that

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[2] In addition, I assume that the variable unit cost, here the shampoo, for either men or women does not change with the number of customers served.

customer, the stylist would not recover the fixed costs of operation. Obviously such pricing could not be sustained in the long run, because eventually stylists would cease operating.

22. Similarly, if a stylist charged male and female customers identical prices despite higher variable costs of serving female customers, then margins for male customers would exceed those earned on female customers. Such pricing could not be sustained because stylists would try to expand service to male customers in an effort to increase profits, perhaps by cutting price for male customers. This would have the effect of displacing female customers and increasing the firm's profits and creating pressure for margins to be equalized.

23. This process would continue until margins for the two types of customers were equalized. The relative prices of the two services would settle where price differences reflected differences in the variable costs associated with serving each type of customer.[3] In this manner, the relative prices of the two services would settle at the point where a competitive firm would be indifferent to serving either men or women.[4] In a world of perfect competition, price differences would reflect differences in the variable cost of serving various customers, even if there were differences in the market elasticities of demand in hair styling services for men and women.

24. This example, although very simplified, illustrates the competitive outcome when multiple-service firms face common fixed costs and product-specific differences in variable costs associated with a unit of output. As discussed below, roughly similar cost conditions

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[3] This example has made the simplifying assumption that the stylist's time does not differ between serving a male or female customer. If the time required to serve men and women differed, and this is the only difference in costs between men and women, then competition would equalize margins per unit of time expended.

[4] The assumptions of competition and the absence of entry barriers would ensure that stylists would enter (or exit) the industry until the economic profits of each stylist were driven to zero.

occur in the payphone industry and similar pricing outcomes would be expected under competition.

C. COMPETITIVE PRICING FOR PAYPHONE ACCESS SERVICES

25. As discussed above, payphones provide a variety of access services. The production of these services involve significant common fixed costs. This section reviews how prices for various payphone access service would be determined under competition. I follow the example discussed above and assume that payphones are fully utilized; that the demand for payphone access services is known and inversely related to price; that there are no barriers to entry into the provision of payphone services; and that calls of various types (local coin, dial-around, 800) all are the same average length. I also assume that the variable costs associated with various types of calls differ, but are the same for all calls of a particular type.

26. As in the above example, competition in the provision of payphone access services would result in prices that exceed the variable cost of providing a service (conditional on the phone being provided). To see this, assume that the variable cost of providing any service is zero once a phone is installed. A positive price emerges not only to limit demand but also to recover the fixed cost of the phone through revenue earned. If the PSP charged a price for the service equal only to the variable cost of providing the service, assumed here to be zero, the PSP's revenue would be zero as well and would not cover the fixed costs of providing a service. Although this example assumes zero variable costs, the point is general. Under a pricing scheme in which price just equals the variable costs of providing a unit of service, revenue will not cover fixed costs and phones will not be installed. As supporting evidence, note that the $0.35 rate for local coin calls that predominates in what the FCC agrees is a competitive marketplace for local coin calls exceed the variable cost to a PSP of providing such

a call. Thus, competition will cause the equilibrium price to yield revenues that just cover the fixed cost of the phone -- economic profits will be zero.

27. Under competition, the margins earned for different payphone access services would be equalized. If, for example, margins earned on local coin calls were higher than margins earned for dial-around service, then firms would find it profitable to reduce slightly the price of local coin calls and increase slightly the price of access for dial-around calls. This would attract consumers from rival providers' payphone services and induce consumers to increase their use of payphones for local coin calls, thus displacing the lower margin dial-around calls.[5]

28. Under competition, each payphone would earn zero profit and payphone providers would face no incentive either to expand or to reduce the number of payphones in the marketplace.[6] The competitive process would result in the provision of the economically efficient number of payphones, with firms having no incentive either to increase or decrease the number of payphones deployed.

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[5] If different types of calls are of different lengths, then margins per unit of time would be equalized for various payphone access services.

[6] If payphones differ, perhaps because of locational differences, then all statements about profits being driven to zero and margins being equalized across different services apply to the marginal payphone -- the last one to enter that earns no profits.

D. THIS SIMPLE ANALYSIS IS INSTRUCTIVE EVEN WHEN SOME OF THE ASSUMPTIONS ARE RELAXED

29. The analysis to this point has made several simplifying assumptions. For example, the discussion above is based on the assumption that PSPs face certain industry demand and that payphones are fully utilized. However, the basic conclusions from this analysis hold even when these assumptions are relaxed.

30. Suppose, for example, there is a random component to market demand and prices are set in advance, so that payphones may not be fully utilized after the random component is realized. Under these circumstances, competition would still equalize "expected margins" for different types of services. Even with uncertainty, the use of a payphone for one service (coin operated calls) imposes an opportunity cost on the payphone provider by preventing an expected use of that phone for other types of calls. Under these circumstances, firms still have an incentive to lower prices on services that yield higher expected margins (in order to gain customers for that type of service from rivals), in turn displacing services that yield lower expected margins.

31. The same result, however, may not hold in the absence of competitive conditions (even if the market succeeds in pricing each of the relevant services). But, the FCC appears to seek a solution that approximates what would arise in a competitive market.[7] This competitive benchmark also appears to be a natural starting point for attempting to remedy a pricing failure. My analysis shows that a competitive market would yield margins that are equalized across services.

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[7] The FCC states "[t]he record ... supports our prior conclusion that per-call compensation should be set by the market place and that full and unfettered competition is the best mechanism to achieve Congress' dual policy objections." FCC, Second Report and Order, CC Docket No. 96-128, October 9, 1997.

IV. THE FCC'S AVOIDED COST METHODOLOGY APPROXIMATES THE OUTCOME IN A COMPETITIVE MARKET FOR PAYPHONE SERVICES

A. THE FCC'S METHODOLOGY STRIVES TO EQUALIZE MARGINS FOR DIFFERENT TYPES OF PAYPHONE SERVICES

32. The FCC has proposed that compensation to PSPs for providing access for dial-around and 800 calls should be based on the compensation they receive for providing access for local calls. The local call compensation, however, is to be adjusted to reflect the FCC-determined estimate of the costs that PSPs "avoid" by providing access to dial around and 800 calls (instead of local coin calls). The FCC estimates that roughly seven cents in costs are "avoided" in making dial-around and 800 calls instead of local coin calls.[8]

33. The FCC's "avoided cost" methodology attempts to equalize margins earned on local coin calls and dial-around/800 calls. By attempting to maintain this parity, the FCC's proposed methodology approximates pricing for various payphone access services that would be expected under competition.

34. I am aware of no data suggesting that PSPs face different costs in providing dial-around and 800 calls. The absence of a distinction in PSP compensation for such calls approximates the competitive result, as long as there is no difference in costs of providing access for such calls. In addition, I am not aware of data suggesting that local coin calls, dial-around calls and 800 calls differ systematically in length.

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[8] During an interim period, compensation for dial-around and 800 calls would be roughly $0.28, a rate which reflects the prevailing $0.35 rate for local calls less its estimate of the difference in costs.

B. THE FCC'S USE OF THE LOCAL COIN-RATE APPEARS TO BE A REASONABLE BENCHMARK RATE

35. The payphone industry was deregulated by the 1996 Telecommunications Act and accompanying FCC rules. These changes were based on a recognition that there are few, if any, barriers to entry into the provision of payphone services and that hundreds of independent payphone service providers had entered into the industry to challenge the regulated payphone operations of incumbent local exchange providers.[9] The 1996 Telecommunications Act also eliminated historical subsidies earned by local exchange carriers for providing payphone services. Given these industry characteristics, and the recognition that the provision of payphone services raises none of the market power concerns associated with the provision of local exchange services, the market-determined rate for providing access for local coin calls appears to be a sensible competitive benchmark for establishing rates for other payphone access services.

36. The local coin-rate also provides a useful starting point for determining the price of other payphone access services. The use of the local coin rate in the avoided cost framework means that changes in demand and supply conditions automatically change compensation rates for dial-around and 800 calls. For example, if market forces gave rise to local call coin rates that differ by time of day or by geographic area, compensation on dial-around/800 calls would adjust automatically to preserve equal margins for various types of calls. This is a highly desirable mechanism assuming that changes in market conditions affect payphone access rates equally.

37. I understand that some question the usefulness of the local coin-rate as a

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[9] FCC, Report and Order, CC Docket No. 96-128, ¶232 (September 20, 1996).

benchmark rate for the avoided cost methodology because local coin-rates typically are denominated in nickels (as a result perhaps of the high collection costs associated with rates denominated in pennies). However, this does not appear to be a significant limitation of the FCC's avoided cost methodology. This type of pricing indivisibility characterizes many commodities and does not reflect a market rigidity. For example, nickel-denominated pricing appears to be ubiquitous in vending machines, of which payphones may be considered just one type. If prices were (slightly) elevated or (slightly) reduced as a result of such pricing, firms would have a small additional incentive to expand or contract the numbers of payphones deployed.

C. DIAL-AROUND/800 RATES SHOULD NOT BE BASED ON A "BOTTOM UP" COST CALCULATION

38. I understand that some interexchange carriers have proposed a "bottom up" cost approach to setting dial around/800 compensation as an alternative to the FCC's avoided cost methodology. As a general matter, a "bottom up" cost approach would approximate the pricing that would arise under competition only as a matter of coincidence. Thus use of this approach would generally result in an economically inefficient provision of payphone services.

39. Cost-based approaches, such as that proposed by AT&T, generally attempt to derive a single "average" cost for providing non-coin payphone access services. Even if there is agreement that such an average cost is being calculated correctly, the use of a single number in setting compensation for dial-around and 800 calls is of limited value because it is unlikely that the same competitive price will prevail in all areas for all such calls. While calculations of average costs specific to particular PSPs and areas is possible as a theoretical matter, implementation of such calculations is likely to be impractical at best.

40. Moreover, the record in this proceeding provides strong evidence regarding the ambiguities involved in performing such calculations. AT&T, for example, estimates that the average cost of a non-coin payphone call is roughly $0.14.[10] The FCC, on the other hand, estimates this cost to be roughly $0.25, a figure roughly 75 percent above AT&T's estimate.[11] The Coalition argues that the FCC's figures are too low. These figures underscore the inherent uncertainties associated with cost-base rate regulation and reinforce the benefits of using market based coin rates as the starting point in determining dial-around and 800 compensation.

41. AT&T's estimate of the cost of non-coin calls appears to be well below the competitive level, as implied by the avoided cost methodology. Failure to properly compensate PSPs for providing dial-around and 800 access would lead to an inefficient restriction in payphone deployment.

V. CONCLUSIONS

42. The FCC and the courts have struggled to establish an economically appropriate mechanism for compensating PSPs for the provision of dial-around and 800 subscriber access calls. I conclude that the FCC's avoided cost methodology approaches this result, in the sense that it yields the approximate price that PSPs would be expected to receive under competitive circumstances for providing access for dial around and 800 calls.

43. Under competitive conditions, the prices for payphone services of different types of access services would have the following characteristics: (i) the price of any service will exceed its marginal or variable costs, conditional on service being provided; and (ii) each

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[10] Affidavit of David C. Robinson, Nov. 26, 1997, Attachment II.

[11] FCC, Second Report and Order, CC Docket No. 96-128 (October 9, 1997), ¶108.

service will be priced so that the margins (defined as price less variable costs) across the different services will be equalized.

44. I also conclude that, except by coincidence, cost-based pricing algorithms, such as that proposed by AT&T, would not achieve the competitive result of equalizing margins across the various access services offered by the PSPs. AT&T's cost estimates are significantly below the FCC's and the Coalition's, and well below the price implied by the avoided cost methodology. Thus, application of AT&T's "bottom up" approach would be expected to lead to an inefficient restriction in the deployment of payphones.

Gary Becker

7/10/98

Date

GARY STANLEY BECKER **May 1998**

Address: Department of Economics
University of Chicago
1126 East 59th Street
Chicago, Illinois 60637

Phone: 312-702-8168
Fax: 312-702-8490

EDUCATION

A.B., Princeton University, 1951 (Summa Cum Laude)
A.M., University of Chicago, 1953
Ph.D., University of Chicago, 1955

Honorary Degrees

Doctor Philosophae Honoris Causa, Hebrew University, Jerusalem, Israel, 1985
Doctor of Laws, Knox College, Galesburg, Illinois, 1985
Doctor of Arts, University of Illinois at Chicago, Chicago, Illinois, 1988
Doctor of Science, State University of NY at Stony Brook, Stony Brook, NY, 1990
Doctor of Humane Letters, Princeton University, Princeton, New Jersey, 1991
Doctor Philosophae Honoris Causa, University of Palermo, Buenos Aires, Argentine, 1993
Doctor of Humane Letters, Columbia University in the City of New York, 1993

PROFESSIONAL AFFILIATIONS

Academic Appointments

University Professor, University of Chicago, Dept. of Economics and Sociology, 1983 - present; Dept. of Economics, 1970-1983; Chairman, Dept. of Economics, 1984-1985
Ford Foundation Visiting Professor of Economics, University of Chicago, 1960-70
Arthur Lehman Professor of Economics, Columbia University, 1968-69
Professor of Economics, Columbia University, 1960 - 1968
Assistant and Associate Professor of Economics, Columbia University, 1957-60
Assistant Professor, University of Chicago, 1954-57

Professional Appointments

Columnist, Business Week, 1985-present
Research Associates, Economics Research Center, N.O.R.C., 1980-present
Senior Fellow, Hoover Institution, 1990-present
Members, Domestic Advisory Board, Hoover Institution, 1973-1991
Academic Advisory Board, American Enterprise Institute for Public Policy Research, 1987-91
Associate Member, Institute of Fiscal & Monetary Policy, Ministry of Finance, Japan, 1988-present;
Member, Senior Research Associate and research policy advisor to the Center for Economic analysis of Human Behavior and social Institutions, National Bureau of Economic Research, 1957-79
Board of Publications, University of Chicago Press, 1971-75

Professional Societies

American Economic Association (Distinguished Fellow, 1988; President, 1987; Vice President, 1974; Editorial Board, American Economic Review, 1968-71
American Statistical Association - 1955
Econometric Society
Mont Pelerin Society, 1971 (Executive Board, 1985-, Vice President, 1989, President, 1990-92)

Elected Societies

Member, National Academy of Sciences, 1975-
Member, American Philosophical Society, 1986-
Fellow, American Statistical Association, 1965
Fellow, Econometric Society, 1967
Founding Member, National Academy of Education, 1965, (Vice President, 1965-67)
Fellow, American Academy of Arts and Sciences, 1972-
Member, International Union for the Scientific Study of Population, 1982-
Fellow, National Association of Business Economists - 1993
Phi Beta Kappa, Princeton University, 1950

Awards

W.S. Woytinsky Award, for Human Capital, University of Michigan, 1964
John Bates Clark Medal, American Economic Association, 1967
Professional Achievement Award, University of Chicago Alumni Association, 1968
Frank E. Seidman Distinguished Award in Political Economy, 1985
MERIT Award, National Institutes of Health, U.S. Dept. of Health and Human Services, 1986
John R. Commons Award, Omicron Delta Epsilon, 1987
Noble Prize for Economic Science, 1992

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DECLARATION OF ALFRED E. KAHN

I, Alfred E. Kahn, do hereby declare as follows:

I. INTRODUCTION AND SUMMARY

The purpose of this affidavit is to support the Comments of the RBOC/GTE/SNET Payphone Coalition in the following respects:

1. It was reasonable for the Federal Communications Commission to have expressed confidence, in its Second Report and Order of October 9, 1997, "that market forces will keep the payphone prices at competitive levels...." (par. 118)

2. Given the legitimacy of that finding, it was both economically efficient and fully compliant both with the general intention of the Telecommunications Act to establish a "pro-competitive deregulatory national policy framework" and with its explicit instruction to "establish a per call compensation plan to ensure that all payphone service providers are fairly compensated for each and every completed...call using their payphone"[1] for the Commission to base its prescribed default rate for 800 and dial-around calls on the observed market price for coin calls, and then

3. to adjust that market price for any differences between the avoidable or incremental cost of those services and the coin calling services to which the observed market rate applies.

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[1] Section 276 (b)(1).

4. Development of a cost-based default rate from the ground up, instead, would be administratively cumbersome; invite arbitrary cost allocations or require highly uncertain and contentious estimates of the relative demand elasticities of the several services; entail the familiar inefficiencies of cost-plus regulation; inevitably involve cost averaging, which would do a much poorer and less efficient job than the competitive market in reflecting differences in cost at different locations and, by so doing, interfere with the efficient deployment of payphones; and violate the clear intention of the Act to rely to the greatest extent possible on the unregulated, competitive market to make such determinations.

5. The Commission's adjustment of the local coin rate for avoidable costs was economically erroneous in at least one critical respect: if the facts are as I have been informed, coin mechanism capital costs should not have been treated as avoidable costs of coinless calling.

II. THE REASONABLENESS AND RELEVANCE OF THE COMMISSION'S DETERMINATION OF THE SUFFICIENCY OF "MARKET FORCES" IN COIN CALLING

I have not myself conducted a study of the payphone market sufficient to permit me to conclude that it is indeed effectively competitive. As I understand it, the Payphone Coalition is submitting testimony by other witnesses in support of that conclusion. I have no basis whatever, however, for disagreeing with the Commission's declaration of "confiden[ce] that market forces will keep payphone prices at competitive levels." (Second Order, par. 118) Entry into the market is easy; and the combination of requirements for clear disclosure of charges, on

the one hand, and the impracticability of payphones discriminating between informed and uninformed, discretionary and emergency callers could clearly, in my judgment, justify a conclusion that any locational monopoly made possible by buyer ignorance or the inconvenience of shopping around does not render unregulated competition insufficient to protect consumers. If such a finding is reasonable—and the Commission has the authority to make it—it *means* that competition is sufficient to hold prices reasonably *close to cost*. As the Circuit Court itself correctly observed,

> the premise that the market rate for coin calls generally reflects the costs of those calls. ...would hold true in a competitive market in which costs and rate [sic] converge." (p. 5)

The Court apparently was not satisfied, however, that the FCC had been sufficiently explicit in its finding that the market for local coin calls was competitive and that the local coin rate therefore reflects providers' costs. In principle, however, there is really no distinction between the Commission's finding that "market forces generally will keep prices at reasonable levels"—a finding the reasonableness of which the Court affirmed—and "the question of whether coin call rates converge with costs." (p. 6) "Reasonable" prices *are* prices reflecting costs: that is an ancient regulatory principle. A statement that "market forces" will keep prices at such a level is—in both longstanding regulatory parlance and elementary economic principle—at one and the same time a justification for deregulating the market *and* a conclusion that "coin call rates converge with costs." The distinction that the Court draws between those two findings is non-existent. It follows also that compensation of sellers of several services at such levels (adjusted for any cost differences among them) is "fair," within the terms of the Act.

By the same reasoning, the Court's criticism

> The Commission never explained why a market-based rate for coinless calls could be derived by subtracting *costs* from a *rate* charged for coin calls. If costs and rates depend on different factors, as they sometimes do, then this procedure would resemble subtracting apples from oranges[2]

suggests that the Commission need only make explicit what is already implicit in its approach:

> *Rates* disciplined by competitive market forces *are* rates approximating *costs*; the subtraction of *costs* from such *rates*, therefore, involves subtracting *costs* from *costs*—not apples from oranges.

Given its finding about the sufficiency of market forces to hold charges for *coin calls* to cost, the question remains: what was the logic of the Commission basing its prescribed default rates for 800 and dial-around calls, which it is apparently universally agreed must continue to be regulated, on the prevailing market-determined rates for coin calls? The easiest way to answer the question is to confront AT&T's objection—based upon the correct assertion by its economic expert, Dr. Frederick Warren-Boulton, that "local coin calls and coinless toll calls are independent goods"[3] and that, therefore, "local coin calls and coinless calls are not even in the same market."[4] This correct observation, *from the demand side* (as he explicitly recognizes), ignores the critically relevant fact that *from the supply side* the two categories of calls are common products, supplied by the same equipment;[5] and if the market price of the one may

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[2] U.S. Court of Appeals No. 97-1675, *MCI Telecommunications Corporation, et al., v. Federal Communications Commission and United States of America*, Argued May 8, 1998, Decided May 15, 1998, p. 5.

[3] *Declaration* (apparently undated), p. 2.

[4] This second assertion is AT&T's, *AT&T Petition for Reconsideration*, December 1, 1997, p. i. See also:

> A market-based approach to setting the default payphone compensation rate must recognize that there are two *independent* markets that must be considered....

Ibid., p. 5. I do not find it in Dr. Warren-Boulton's *Declaration.*

[5] As Dr. Warren-Boulton correctly observes, "Any relationship between the two types of calls would appear to be on the supply side only." (p. 2)

properly be regarded as reflecting the cost of supplying it, so may the regulated price of the other be based on that same market price, provided only that it is adjusted for any differences in their several costs, as the FCC has attempted to do. The fact that size 10 and size 8 shoes that are in all other respects identical are, similarly, non-substitutable for one another does not mean that their costs may not logically be presumed to be the same, provided they are adjusted for identifiable differences in those costs—such as the amount of materials in each.

AT&T converts Dr. Warren-Boulton's plausible statement about the independence of the *demands* for the two kinds of calls into a proffered, thoroughly irrational, refutation of the foregoing justification of what the FCC has done from the *supply* side—an argument for which I find no counterpart or justification anywhere in his Declaration:[6]

> coin-specific costs are *not* 'joint and common' with costs of coinless calls because '[l]ocal coin calls are effectively a final product provided by the pay phone operator, whereas pay phone access to coinless toll calls is a *derived* demand for pay phone access to toll calls,' so that the rate for the former cannot be used to calculate the costs of the latter.[7]

Observe that this statement (a) focuses on the single component of those costs—"coin-specific costs"—that are arguably *not* joint or common (but see our discussion of the implications of that fact, in Section IV., below)—which is, of course, why the FCC adjusts the regulated rate for that admitted difference—thereby in effect admitting that the preponderance of the other costs are indeed common; and (b) merely harks back to the differences in their *demands*, not their conditions of supply. In so doing, AT&T conveniently ignores its expert witness' rather

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[6] On the contrary, it ignores his backhand admission of the "apparent" relationship between them "on the supply side." See note 5, immediately preceding.

[7] *Ibid.*, p. 5. The quotations within that statement are indeed Dr. Warren-Boulton's; but the interpolated words and the inferences drawn are AT&T's, not his.

grudging, backhand admission of the relationship "between the two types of calls...on the supply side...."[8]—that is, the fact that the preponderance of their costs are indeed common.

> Finally, the implication that both he and AT&T draw—
>
> as Dr. Warren-Boulton explained, tying payphone compensation for coinless calls to the rates for local coin calls, would provide PSPs with an incentive to raise the price of local coin calls above the profit-maximizing level in order to increase their total return ... (*Ibid.*)—

simply ignores the FCC's finding that the latter rates will in fact be sufficiently constrained by competition, no matter what the "incentives" of the PSPs. Manifestly, if the FCC's finding is correct, any effort by the PSPs to "increase their total return" in this way would be frustrated by competitive undermining and entry.

III. THE SUPERIORITY OF MARKET-BASED OVER ADMINISTRATIVELY DETERMINED RATES

There appears to be no disagreement with the necessity of the FCC actually prescribing a default rate for dial-around and 800 calls, because they require no initial deposit of a coin and, since payphone owners are legally prohibited from refusing such calls, they have no means of forcing the long-distance carriers or the subscribers to the 800 service to pay them, and the latter companies have no incentive either to offer compensation or to bargain in good faith over the terms.

In view of the clearly expressed statutory preference for competitively determined rates and the apparently ample authority of the FCC to find competitive forces sufficient to protect legitimate consumer interests, an exposition by an economist and former regulator of the

[8] See note 5, above.

reasons for his agreement with that preference is perhaps superfluous. Since, however, the FCC is under statutory instruction to set the rate at which payphone owners are to be compensated for 800 and dial-around calls itself, it may be helpful to explain why beginning the process with market-determined prices and then adjusting them for *differences* in the cost of the coin and non-coin calls would be both more efficient and more equitable than an attempt to build cost-based rates for those calls from ground zero.

In brief,

- regulatory determination of the relevant costs, from the ground up, is inevitably more contentious, necessarily involving controversies over proper levels of cost, including reasonable rates of return and proper rates of compensation or divisions of revenue between the owner/operator of the equipment and the owner of the location of its installation. The contentiousness of negotiations over the proper cost-based prices for unbundled network elements to be supplied by ILECs to CLECs pursuant to sections 251 and 252 of the 1996 Act provides a graphic illustration of the difficulty of administering a cost-based standard such as AT&T urges on the Commission here.

- Economically efficient prices would have to be based on incremental costs. But rates set at that level for coin- and non-coin calls, respectively, would fall far short of recovering total costs: their short-run incremental costs must be small; and so would the total-service long-run incremental costs (TSLRIC) of either of them,